Earlier this month I found myself on the Great Wall of China on a cold, sunny day. The easiest way to the top is by cable car, but there are a number of ways to get down, including riding a small, somewhat rickety sled down a primitive chute, turning bends and gathering speed. It’s about a 20-minute ride to the bottom and it occasionally feels like you are losing control. It’s a fitting metaphor for a major policy dispute that is now gathering force and could quickly elude careful handling by the Washington and Beijing: a dispute over the relative values of the two nation’s currencies.

Washington is intensifying its efforts to officially accuse China of artificially holding down its currency, the yuan, to gain unfair trade advantage. The U.S. Treasury could be on course to brand China as a “currency manipulator” in its biannual report on foreign exchange developments due out on April 15. Were Treasury Secretary Tim Geithner to charge China as cheating on international rules by being aggressively mercantilist, U.S. law would require Washington to immediately enter negotiations with Beijing to allow the yuan to appreciate. This could be done bilaterally, or the U.S. could try to enlist some other countries to help under, say, the auspices of the International Monetary Fund. If either of those efforts failed, the U.S. could impose large across-the-board tariffs on all imports from China – including computers, electronics, toys and clothing.

Perhaps China would cave before such trade barriers were imposed, not wanting trouble in its most important export market. Alternatively, the U.S. could get cold feet. China recently announced it was likely to see a trade deficit in March, and
although no one can be sure if China is manipulating the figures to make appreciation of its currency seem unnecessary, the U.S. could use that argument to postpone any accusations. But neither course is likely, in my view, and watching the debate in the U.S. and looking at what Chinese officials are saying overtly and in between the lines, there is a big risk of serious miscalculation in Washington and in Beijing, one that could lead to major turmoil in international financial markets, an outburst of serious protectionism and a double-dip recession.

To better understand what could go wrong, it’s not particularly useful to obsess about the technical merits of whether the yuan is significantly undervalued. Although Chinese Premier Wen Jiabao recently told an international audience that there was no truth to the charges, most economists would calculate that the yuan, which China firmly links at 6.8 yuan to $1, is too cheap by 20% to 40%. The International Monetary Fund and the World Bank have both stated that the yuan is misaligned, too. But there are many ways to calculate the appropriate value of a currency and in this case what matters much more are deep-seated perceptions and political considerations.

I got a sense of these perceptions when I took a small group of students to Shanghai, Beijing and Hong Kong in mid-March for a closer look at the Chinese financial system. Over six business days, we had over 20 sessions with senior men and women from Chinese and foreign banks, private equity and venture capital funds, stock exchanges and regulatory agencies, all of whom are inclined to be much more open than they would otherwise be, especially with students in off-the-record give- and-takes.

Many Chinese leaders believe that everything that the Obama administration does is geared to short-term political calculations, much of it focused on this November’s mid-term elections. (I was particularly taken by how many of them follow President Obama’s remarks carefully, and know the positions of leading senators and congressmen.) Beijing thinks that Washington’s uproar over the yuan is about America’s 9.7% unemployment rate and the fact that a high level of joblessness will continue for years. They see the end of the stimulus programs,
the prospect of the Fed tightening conditions, and the search to focus on something else – specifically the trade deficit, where China accounts for the lion’s share once petroleum imports are stripped out. China’s political diagnosis is mostly right, of course, but it would be making a mistake if it thought that such pressures would not intensify and endure. Moreover, Beijing may underestimate how much of a consensus is now building to try to clobber China, if necessary.

The U.S., on the other hand, may not have a clear view of how China sees the world. By all appearances, China continues to admire most things American and has no intention of turning away from a gradual path toward more flexible and open markets. At the same time, there is deep disappointment among Chinese leaders about what they consider to be the scandalous lack of responsibility on the part of America’s financial institutions and regulators that led to the credit crisis and the subsequent recession. China believes that the currency debate is little more than an attempt to get China to help the U.S. out of a made-in-America problem. They seem to be in no mood to take American advice, which has been delivered so publicly, on how to manage their economy. Beyond that, China has at least three major concerns.

First, although China’s GDP is growing at 8%-10% annually, Beijing also has a deep concern about unemployment. At the heart of the financial crisis last year, it had to dismiss some 20 million migrant workers who had come to work in the cities and send them back to their poor villages. China must generate about 10 million new jobs to maintain social stability. Beijing is worried that the weak economic conditions of the debt-strapped West will crimp its sales abroad. Surveys show that most Chinese exporters work with a 2% to 3% profit margin, so even a small appreciation of the yuan could spell large-scale layoffs.

Another Chinese reservation is the belief that the currency adjustments the U.S. is demanding will have scant results. Were China to revalue the yuan by 5% to 20% - - the most it would do, in my view -- that would hardly offset the wage advantages it has, such as labor costs of 10% to 20% of U.S. levels, or annual salaries for scientists and engineers of about $12,000. So Beijing is quite convinced that a small revaluation will not buy it any good will beyond a month or
two. Between 2005 and 2008, China did in fact allow the yuan to appreciate against the dollar by 20%, and the U.S. trade deficit still deteriorated. China is also well aware of the case of Japan, where U.S. arm twisting to revalue the yen in the late 1980s and early 1990s had virtually no trade impact, either.

The Chinese government also resents the inference that it is behaving irresponsibly. It believes it has been a bastion of stability in both the Asian financial crisis of the late 1990s, where its fixed exchange rate stood out from the crumbling currencies from South Korea to Indonesia. It feels that in the recent global credit implosion, its fixed rate and massive stimulus program helped save the world economy.

There are a number of reasons why the U.S. push on the yuan could go awry. In China there seems to be considerable understanding that sooner or later the yuan will have to find a new level. In my conversations, two officials likened the country to a gigantic canyon filling up with reserves that would soon be overflowing. Canals to the outside world will have to be built to relieve the pressure, they said. Another Chinese leader said that the yuan would of course be revalued, but when and to what extent was still being hotly debated. I worry that intense American pressure on the Chinese government could actually force Beijing to coalesce around resistance to revaluation—nationalism being what it is—just at the time when the debate is gathering steam.

Indeed, it looks as if Washington hasn’t got the message that it can no longer successfully brandish a big unilateral club, especially in the global economic arena. The financial crisis hastened the shift of economic power from West to East that was already occurring. For decades to come, according to the Congressional Budget Office and many other reputable institutions, America will be swimming in debt and cutting back on its domestic programs and international commitments. On the other hand, China’s $2.4 trillion in reserves give it an extraordinary range of investment options. Many Washington officials are convinced that China would never take advantage of being America’s major creditor, because it is already so invested in the U.S. But in the end, who really knows? The point is, there is a complex, unknowable and ultimately dangerous psychology at work when the
U.S. feels its power being gradually eclipsed, while China knows it is ascending in the world.

In the case that the U.S. does go ahead and tries to force China to revalue the yuan, what could be the consequences if China doesn’t agree?

No one should be surprised if the global financial system goes into gyrations. In 1987, something akin to this kind of clash happened. The world economy was very fragile and the U.S. had a public dispute with Germany over the value of the Deutsche mark. Two days later, on Oct. 19, the world’s stock markets crashed.

In addition, if the world’s two largest trading nations come to blows with the U.S. imposing high tariffs on Chinese goods, that could unleash retaliation and a raft of protectionist pressures that are just below the surface, especially with high unemployment in the West, made worse by upcoming fiscal austerity that will cut into social safety nets. An added reason for apprehension is that in response to the global economic downturn, every country is trying to export itself out of this mess. President Obama has just proposed an ambitious plan to double exports in five years, China is holding on to its cheap currency, Europeans are secretly delighted an ever lower euro, and Japan is making noises that the yen is too strong. This has the makings of competitive devaluations, the pernicious trend that helped to dry up trade in the 1930s.

The only way out of this dismal scenario would be for the U.S. and China to defuse their emerging collision right now. The U.S. would not label China as a currency manipulator, and both countries would agree to hold talks about a number of issues, the yuan being just one item.

On the agenda would also be other measures that are fundamentally much more important than minor currency adjustments. For China that would include commitments to domestic policies that would encourage Chinese consumers to save less and spend more, including on imports. A good example of what Beijing could do would be to vastly enhance the primitive social security system so that Chinese citizens don’t have to save so much for their later years. China could also
commit to make its currency freely convertible into others – something that it hasn’t allowed yet, so that it moves more quickly to a market-oriented system.

The U.S. would have to agree to measures that will lead to more savings and less consumption – a move that would reduce the trade deficit and foster more investment in America – via, say, a national consumption tax. It would have to commit itself to give priority to high tech manufacturing, so that it has real industries to absorb jobs and also tangible products to export abroad.

A few other key nations would have to join these talks, because in a global economy the only measures that work are multilateral ones. Germany, for example, is running huge trade surpluses and should save less and consume more, just as China must.

To put it all another way, we need more demand from abroad and we need more supply coming from the U.S., just the opposite of how the world economy has been organized for the past 50 years. Achieving this could be the most important set of economic negotiations in a generation—and the ultimate challenge for our financial diplomats.

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